Henshaw/Vierra Management Counsel, L.L.C.

Payroll Tribune

Volume 4, Issue 4 February 2009

2008 was a Game Changer

In mid- January 2009 I listened to a presentation by Mohamed El-Erian the Co-CEO and CIO of PIMCO, one of the nation's best bond managers. He said that 2008 was a year where "the unthinkable was thinkable", and that 2009 would be the year where the economy would be on "a bumpy journey to a different destination".

The "unthinkable" in 2008 turned out to be: a crisis within the capitalist system, a time when U. S. financial markets were redefined, and a time when scared policy makers had no plans. They just reacted, and gave us a market where unemployment moved up very fast on its way to 9/10%, credits markets froze, and the economy held its breath.

We have talked about how this occurred in past Payroll Tribunes (see them at www.henshawvierra.com): structural weaknesses, massive financial innovation collapses, and no circuit breakers in the System. So now we all have a new partner -- the Government, which will act as both regulator and major player in the markets.

The Government will change the economic game and take us to a "different destination" because government officials are not bound by "commercial" priorities or logic, they view risk differently, and they have different objectives.

The payroll business will survive in this new environment. It is a necessary service which bureaus can deliver to their customers accurately, reliably, and economically. The newly elected government is even talking about looking at payroll taxes and other changes which will make outsourced payroll, H/R reporting, and benefits administration an even more valuable business.

The government will focus on employment, and 80% of that employment comes from companies with from one to 250 employees, most service bureaus key target market.

The government will also focus on regulation of key sectors in the economy. Banks will be consolidated and key organizations nationalized. Bureaus must get ready today for more regulation.

Maintaining Operating Margins When Government Is Calling The Shots

You maintain operating margins by providing your customers with extraordinary services at a fair price, under any market conditions. Your operating margins are a function of three basic actions you can take: expanding revenues, controlling expenditures, and managing risk.

Revenues

You can expand your revenue by increasing your volume of customers, by increasing the volume of services you provide them, and by changing your prices.

The reports I am getting from the field are that Q1 09 new account volumes generally met quota around the country. Further, account attrition did not expand, although bureau managers expect check counts to fall as unemployment increases.

Core service bureau product offerings in general have expanded to include payroll, taxes service, direct deposit, time clocks, H/R and retirement/benefit services. If your product offering does not include each of those services, sold to more of your existing customers, you are losing revenue potential.

Pricing changes take a little more planning. Most bureaus will average a 3% price increase this year. I know that a major player discounted heavily during the Q1 selling season. 3 to 5 months of "free" service was offered, one day deposits were claimed to be offered (really? A major player would not encourage kiting checks in an environment like this, would they?), and $2 a W-2 and 1099 for restaurants was even reported to me. If any of these pricing tactics happened in your market, think about putting out an offer to potential customers you lost to such practices, offering a pricing package that is fair and predictable, with a free conversion to any of Brand X's new customers who get a sharp increase in their price before 30 June 2009.

Maintaining Operating Margins When Government Is Calling The Shots

.Managing Your Tax Revenues and Risks

Today, bureaus still have the costs, but the return on the float has gotten to a point where many bureaus are not getting the profits they were used to. Some are not covering their costs. Most are not getting paid to take on the added risk of a bounced check in a weakening economy.

Consider these good practices in a difficult market to manage your return on your tax service: hire and retain the best people you can, don't "under hire" in this key position; work to shift tax service revenues from one third fees and two thirds interest to 50/50; collect the customer's required balances as soon as you can, not as late as you can; do your homework on the paper you invest in over-night and over time.

The government is prepared to do what they can to stabilize the economy, and we know that one major tool they will use is the management of interest rates. They intend to keep interest rates as low as they can for as long as they can.

But, low rates are a problem for payroll companies because the industry has used a model where one third of the costs of providing their tax service are paid for by charging fees, and two thirds of the costs and much of the operating profits are paid for through compensating balances (float) on tax and payroll related deposits.

Do not try to increase your interest income by chasing yields. The risks in the debt market of illiquidity, credit problems, and fraud are too high. If you buy a troubled asset by chasing yield, your broker may not have the authority or even the capital to buy it back from you.

Stay away from weak credits and securities which trade by appointment. Stay away from "structured products" like principal-protected notes, reverse convertibles, wrapped CD's, market-linked CD's, and return-enhanced notes. Stay away from treasury secured repo funds.

Do look at insured CD's which you buy directly from top rated banks, government agency paper of short maturities, agency discount notes, pre-funded munis from well run muni governments. Begin to look at short term commercial paper from A-1, P-1 companies where you have done a review of the credit and put that review in your credit files.

This remains a market in which return of principle is far more important the return on principle.

Reduce your investment risk by dealing with a company and a custodian you trust, using investment paper which is liquid, well under written, and fully understood by you!

Late Breaking News: monitor the strength of your ACH service provider. Use well capitalized, experienced banks and vendors only. The banking industry is consolidating. Monitor your bank's strength in this changing environment. Use well capitalized third party vendors who have some protection from adverse events including customer illiquidity and failure. A third party vendor blew up in early February. Difficult times call for the very best business practices!

In our next issue we will look at managing your costs and operating risks in this new world of slower growth, lower interest rates, and higher customer related risks. If you have questions in the mean time, please do not hesitate to call (510-749-3225) or e-mail guy@henshawvierra.com. This is new territory. The journey will be bumpy. You are not alone. We are here to help you.

Henshaw/Vierra Management Counsel LLC

We know the payroll business, as owners, managers, and consultants for over 15 years. When it's time to **review** your cash flow and treasury management systems, controls, and procedures; **think** through strategic alternatives; **plan** and **manage** a system conversion, manage change in your company; build and maintain a budget and/or plan for a sale or consolidation, **we can help you** as we have helped dozens of payroll companies around the country.

Call us, in confidence, with your questions at 510-749-3225 or e-mail guy@henshawvierra.com. Visit our website www.henshawvierra.com for IPPA peer group surveys, tools to help right size your firm, and past Payroll Tribunes with advice on managing service bureaus.